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DATE: October 27, 2003

BULLETIN NO: 2003-CU-04-1 (Replaces BULLETIN NO 2003-04)

TO: The Board of Directors and Management of Missouri state-chartered credit unions

SUBJECT: Asset Diversification

Diversification of assets is a basic principle of sound financial management. This principle is based on protection of the credit union's assets by dividing funds among various categories of investments or loans. This is done to help mitigate and manage several types of risk that are associated with any asset. The purpose of this bulletin is to advise management of the need to establish a limit for specific categories of assets. Management needs to review the structure of the credit union's investment and loan portfolios to determine the appropriate mix of assets by maturity, credit quality, and interest rate risk, ensuring appropriate diversification.

Of special note are fixed rate first mortgages and third party controlled sub-prime lending programs.

Higher concentrations in fixed rate loans primarily first mortgages require credit unions to measure and forecast their balance sheet risk. The amount invested in these assets must also be limited to fit the credit union's ALM polices and risk tolerance levels. Any amount over twenty-five percent of assets makes risk mitigation efforts more essential and historically difficult to justify. To adequately protect members' funds, management must adhere to the principle of asset diversification.

Businesses engaging in sub-prime lending have historically experienced higher failure percentages than traditional lenders. Borrowers in this group may have a greater number of circumstances that could adversely affect their ability and/or willingness to repay the loan. Losses cannot be reliably predicted and can vary over a wider range than a portfolio of higher credit quality. These reasons alone dictate this type of lending must be limited in credit union portfolios.

See reverse for continuation of Bulletin 2003-CU-04-1

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Sound management practices dictate the limiting of high-risk portfolios. Consequently, the Division of Credit Unions has established a limit of **ten percent of assets** for third party controlled sub-prime lending. Any deviation from this limit must be supported by a detailed plan approved by the board of directors and the Director of the Division of Credit Unions, consistent with the overall asset liability management program. Management is also strongly encouraged to set and adhere to internal limits for other high-risk programs. Overall, management must determine the potential for higher-than-anticipated losses does not seriously jeopardize the credit union.

The Division of Credit Unions will continue to monitor through the risk based examination program asset diversification. The current rate environment offers credit unions unique member service opportunities, but balance sheet management through effective asset liability management practices must occur.

John P. Smith

John P. Smith, Director **October 27, 2003**